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No. 92-270

In the Supreme Court of the United States

OCTOBER TERM, 1992

PACIFIC FIRST BANK, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

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QUESTION PRESENTED

Whether a savings institution that uses the "percentage of taxable income" method of computing a bad debt reserve deduction under 26 U.S.C. 593(b)(2)(A) must adjust its taxable income, and therefore its allowable bad debt reserve deduction, to reflect net operating loss carrybacks under 26 U.S.C. 172.

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1. a. During the period relevant to this case, petitioner was a mutual savings and loan association. For taxable years 1971 through 1980, instead of deducting bad debts as they became worthless, petitioner maintained a reserve for bad debts and claimed deductions each year for "a reasonable addition to a reserve for bad debts" (26 U.S.C. 593(a); see 26 U.S.C. 166(c) (1976)). Section 593(b) of the Code provides alternative methods for computing additions to this reserve. Petitioner elected the method that calculates the addition to the bad debt reserve as an amount equal to a specified percentage of the taxpayer's "taxable income" for the year of the claimed deduction (Pet. App. 7a-8a). See 26 U.S.C. 593(b)(2)(A). The statute

specifies, *inter alia*, that "taxable income" for this purpose is to be computed "without regard to" the deduction for additions to the bad debt reserve. 26 U.S.C. 593(b)(2)(D)(ii).

b. During 1981 and 1982, petitioner sustained net operating losses in the amounts of $43,459,246 and $27,748,382, respectively (Pet. App. 8a, 28a). Under Section 172(b)(1)(F) of the Code, those losses could be carried back to the ten taxable years preceding the loss years. A net operating loss carried back to a prior year is treated as a deduction for that year (26 U.S.C. 172(a)) and therefore reduces the taxpayer's "taxable income" (and income tax liability) for the prior year.

When petitioner carried its net operating losses back to its prior tax years, and thereby reduced its "taxable income" for those years, petitioner did not also adjust its calculation of the bad debt reserve deductions for those years to reflect the lower, recalculated "taxable income" for each year. This resulted in deficiencies in petitioner's taxes, for Treasury regulations (26 C.F.R. 1.593-6A(b)(5)(vi) and (vii)) expressly require that, in using the "percentage of taxable income" method of computing a bad debt reserve deduction, "taxable income" must reflect any net operating loss carrybacks claimed by the taxpayer.

c. Petitioner sought review of the deficiencies in the Tax Court. Petitioner acknowledged that the Commissioner's recomputation of its bad debt reserve deductions was required by the Treasury regulation, but argued that the regulation is an unreasonable interpretation of the statute and, therefore, invalid (Pet. App. 29a).

The Tax Court, in a reviewed 13-5 opinion, concluded that the regulation is invalid (Pet. App. 26a-

42a). The court held that the bad debt reserve deduction under the percentage of taxable income method should be based on the amount of taxable income *before* net operating loss carrybacks are taken into account (*id.* at 29a-30a, 38a-39a). The court stated that the regulation improperly limits the general tax benefits of the loss carryback provision (26 U.S.C. 172) and reduces the tax benefits of the bad debt reserve deduction "beyond the extent intended by Congress" (Pet. App. 37a).

The dissenting opinion of five Tax Court judges concluded that the regulation is valid (Pet. App. 42a-51a). They pointed out that the term "taxable income" is a "bedrock of our income tax system" (*id.* at 44a) and that the challenged regulation merely gives that term its ordinary, accepted meaning (*ibid.*). They further noted that any interpretation of the term "taxable income" *other than* the interpretation expressed in the challenged regulation would represent "an inconsistent use of the basic principles which have been carefully formulated over the past 75 years" (*ibid.*).

d. The court of appeals reversed (Pet. App. 6a-25a). The court noted that, as this Court has often held, interpretive Treasury regulations must be upheld "if they 'implement the congressional mandate in some reasonable manner' " (*id.* at 12a, quoting *National Muffler Dealers Ass'n* v. *United States*, 440 U.S. 472, 476 (1979)). The court found nothing in the text or history of the statute to indicate that the phrase "taxable income" in Section 593 should not be given its ordinary meaning. Given its ordinary meaning, the loss carryback under Section 172 reduces the "taxable income" of the taxpayer and therefore "appears to" reduce the resulting bad debt reserve deduction under Section 593 (Pet. App. 16a). The

court concluded that the regulation, while not embodying the only possible interpretation of the statutes,[1] represents "a reasonable construction of the text of sections 593 and 172" (Pet. App. 16a) as well as "a reasonable interpretation of the legislative history" of those provisions (*id.* at 18a).[2] The court

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[1] In contending that the current regulation is invalid, petitioner relies largely (as did the Tax Court below (Pet. App. 30a-39a)) on the fact that the current regulation provides a rule contrary to that of a prior regulation that had not included net operating loss carrybacks in calculating "taxable income" under Section 593. It is, however, "well established that the Commissioner may change an earlier interpretation of the law." *Dickman* v. *Commissioner*, 465 U.S. 330, 343 (1984). See *Dixon* v. *United States*, 381 U.S. 68, 72-75 (1965). The interpretation of law embodied in a Treasury regulation is not unalterable, but may be changed by amending the regulation "through exercise by the administrative agency of its continuing rule-making power." *Helvering* v. *Reynolds*, 313 U.S. 428, 432 (1941); see *National Muffler Dealers*, 440 U.S. at 485-486; *Helvering* v. *Wilshire Oil Co.*, 308 U.S. 90, 100-101 (1939); *Manhattan General Equipment Co.* v. *Commissioner*, 297 U.S. 129, 134-135 (1936); see also *Chevron U.S.A. Inc.* v. *Natural Resources Defense Council, Inc.*, 467 U.S. 837, 863 (1984) ("[a]n initial agency interpretation is not instantly carved in stone"). The court of appeals therefore rejected petitioner's claim that the challenged regulation is not entitled to deference (Pet. App. 13a-14a). Accord *Peoples Federal Savings & Loan Ass'n* v. *Commissioner*, 948 F.2d 289, 300-304 (6th Cir. 1991).

[2] Petitioner also contends that the challenged regulation "ignor[es] Congress' clearly expressed intent to set the effective rate of tax at a specific level" (Pet. 10). The Tax Court relied on the same theory, stating that the regulation "increases the effective rate of tax for mutual institutions beyond the extent intended by Congress" (Pet. App. 37a). The court of appeals emphasized, however, that there is no factual basis for that claim because the regulation merely "avoids inequitable windfalls based on the timing of income and losses" (*id.* at 21a). Moreover, nothing in the legislative history indicates whether or not Congress took the effect of net

rejected petitioner's unanchored contention that the regulation "violates the general purpose" of these statutes (*id.* at 21a) and concluded that the regulation is valid.

2. For the reasons carefully set forth by the Ninth Circuit in this case (Pet. App. 1a-25a) and by the Sixth Circuit in addressing the identical issue in *Peoples Federal Savings & Loan Ass'n* v. *Commissioner*, 948 F.2d 289 (1991), the courts of appeals have correctly and uniformly concluded that the challenged regulation is valid. There is no conflict among the circuits nor other reason warranting further review.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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operating loss carrybacks into account in deciding what increase in effective tax rate would be appropriate (*id.* at 22a). The court concluded that, "[a]bsent clearer evidence that Congress considered the effect of the prior regulations, or the need to disregard section 172 losses when calculating the reserve deduction, we cannot usurp the Treasury's congressionally delegated authority to interpret this complex scheme" (*id.* at 22a-23a).